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In the Supreme Court of the United States

OCTOBER TERM, 1946

Nos. 1303, 1304, and 1305

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SINGER SEWING MACHINE COMPANY

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Acting Solictor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the Circuit Court of Appeals for the Third Circuit entered in the above-entitled cause on January 30, 1947.

OPINIONS BELOW

The opinion of the Tax Court (R. 31a–38a)[1] is reported in 5 T. C. 851. The per curiam opinion of the Circuit Court of Appeals (R. 40-41) is reported in 158 F. 2d 982.

[1] The record references are to the Appendix to the brief for the taxpayer filed in the Circuit Court of Appeals and to the appended proceedings in that court.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on January 30, 1947. (R. 41-44). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, when the privilege of filing consolidated returns is withdrawn by statute, a corporation is compelled, under Article 39 (b) of Treasury Regulations 78, to use as its opening inventory in the first separate return the closing inventory in the last consolidated return, that inventory being based on cost to the group and thus containing no intercompany profits.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra,* pp. 15–24.

STATEMENT

The material facts as found by the Tax Court (R. 32a–33a) are substantially as follows:

The taxpayer is a corporation, which filed its separate corporate income tax returns for the calendar years 1934, 1935, 1937, and 1938 on the accrual basis (R. 32a).

The Singer Manufacturing Company (hereinafter called Manufacturing) has always owned all of the stock of the taxpayer. The principal busi-

ness of the taxpayer at all times has been the world-wide sale of sewing machines manufactured by Manufacturing. Manufacturing, the taxpayer, and other affiliated companies joined in filing consolidated returns for the years 1918 through 1933. (R. 32a.)

The taxpayer, in its accounts and in all returns, used inventories taken upon the basis of cost or market, whichever was lower. Its opening inventory for 1918 was $12,138.304. (R. 32.) The items in the 1918 opening inventory, which had been bought from Manufacturing, had been sold to the taxpayer by Manufacturing prior to 1918 at a profit of $6,106,560.24. (R. 33a.)

The closing inventory of the taxpayer, used in the consolidated return for 1933, was $18,422,-333.66. The intercompany profit represented in that inventory was $8,431,575.92. The taxpayer on its separate return for 1934 used as its opening inventory $9,990,757.74, representing cost to Manufacturing ($18,422,333.66, 1933 closing, less $8,431,575.92, intercompany profit therein). It did this under protest in the belief that it was required to do so under the Regulations then in effect. The Commissioner made no change in this item in determining the deficiencies on other grounds (R. 33a).

The Tax Court determined that the correct amount of the taxpayer's opening inventory for 1934 was $16,097,317.98 (R. 33a). Both parties

appealed to the court below which affirmed the decisions of the Tax Court *per curiam*. (R. 40-41)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In failing to apply a Treasury regulation dealing with the precise situation presented by this case, the authority to promulgate which was expressly delegated to the Commissioner by Congress, and consent to which was given by the taxpayer in the manner prescribed by statute.

2. In deciding that the taxpayer's opening inventory of 1934 could be a different amount from the closing inventory of 1933, which is cost to the group with intercompany profits eliminated, under Article 39 (b) of Treasury Regulations 78.

3. In refusing to hold that the correct amount of the taxpayer's opening inventory for 1934, when it filed a separate return after previously having filed consolidated returns, was the same amount as the proper value of its closing inventory for 1933, namely, $9,990,757.74, in accordance with the clear provisions of Article 39 (b) of Treasury Regulations 78.

4. In failing to reverse the decision of the Tax Court because it made a clear-cut error of law.

REASONS FOR GRANTING THE WRIT

1. The Tax Court and the court below, which affirmed the decision of the Tax Court *per curiam*,

[2] Several tax years are involved because the taxpayer filed its returns on the installment sales basis.

clearly erred by disregarding a Treasury regulation covering the precise situation presented by this case, namely, Article 39 (b) of Treasury Regulations 78 (Appendix, *infra*, p. 21), the authority to promulgate which was expressly delegated to the Commissioner by Section 141 (b) of the Revenue Act of 1932[3] (Appendix, *infra*, p. 17), and consent to which was given by the taxpayer in the manner prescribed by Section 141 (a) (Appendix, *infra*, pp. 16–17). Such disregard tends seriously to disrupt the fair and efficient administration of the revenue laws. Both the Tax Court and the court below erroneously assumed that the question was left open to them, under the pertinent Treasury Regulation, to determine the proper amount for the taxpayer's opening inventory of 1934. But since there was a Treasury regulation pertaining to the precise situation, the Tax Court could not disregard it without usurping the authority expressly dele-

[3] The reason that the 1932 Act and the Regulations promulgated thereunder apply in this case is that the Revenue Act of 1934 took away the privilege of filing consolidated returns except for railroad companies. (Section 141.) The last applicable statute is the 1932 Act, and the last applicable Regulations are those promulgated under that Act. Section 113 (a) (11) of the Revenue Act of 1934 (Appendix, *infra*, pp. 18–19) provides in substance that the basis of any property acquired by a corporation after 1929 in any year where a consolidated return was filed under the Revenue Act of 1932 shall be determined under regulations prescribed under Section 141 (b) of that Act. See also Article 113 (a) (11)–1 of Treasury Regulations 86 (Appendix, *infra*, pp. 22–23).

gated to the Commissioner by Congress. Even the taxpayer considered itself bound by the regulation in making its return and used the amount indicated by the regulation. (R. 33a.)

Section 141 (b)[4] of the Revenue Act of 1932 provides that the Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and *after the period of affiliation,* may be determined in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

Section 141 (a) of the Revenue Act of 1932 provides in part that the making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. The taxpayer and other affiliated corporations joined in filing consolidated returns for the years 1918 through 1933 (R. 32a). There-

[4] For the legislative history of the corresponding section of the Revenue Act of 1928, see H. Rep. No. 2, 70th Cong., 1st Sess., pp. 19, 20 (1939–1 Cum. Bull. (Part 2) 384, 397); S. Rep. No. 960, 70th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 409, 419); H. Conference Rep. No. 1882, 70th Cong., 1st Sess., pp. 16–17 (1939–1 Cum. Bull. (Part 2) 444, 448–449).

fore, the taxpayer had given its consent in the manner prescribed by subdivision (a) to all the regulations prescribed by the Commissioner under subsection (b).

Unless the basis of property of a corporation which has filed consolidated returns with its affiliates be fixed and maintained at the cost of the property to the first acquiring member of the group, regardless of any transfers at a gain or loss from one member to another, a part of the group's gain will go untaxed. This is the result of the decisions below—a result plainly foreclosed by the controlling Treasury Regulation which has to do with basis as reflected in inventories. Article 39 (b) of Treasury Regulations 78,[5] prescribed by the Commissioner under the authority delegated by Section 141 (b), provides as follows:

> (b) *Separate Return Made After Consolidated Return.*
>
> If a corporation has been a member of an affiliated group which has made a consoli-

[5] This regulation first appeared in similar form in the corresponding article of Treasury Regulations 75, promulgated under Section 141 (b) of the Revenue Act of 1928. Since Section 141 of the Revenue Act of 1928 was reenacted in substantially the same form in the corresponding section of the Revenue Acts of 1932 and 1934, the regulation may be said to have received legislative sanction.

Article 113 (a) (11)-1 of Treasury Regulations 86 (Appendix, *infra*, pp. 22–23), the general regulation under the basis provisions of the income tax title, states the rule less specifically but incorporates by reference the applicable provisions of the consolidated returns regulations.

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> dated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, corporation S joins in making a consolidated return for 1932 and makes a separate return for 1933. The proper value of its closing inventory for 1932 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1933 will be $90,000.

Applying Article 39 (b) of Treasury Regulations 78 to the facts of this case, the proper value of taxpayer's closing inventory of 1933 after eliminating intercompany profits is $9,990,757.74 (R. 33a). It may be noted that the Tax Court found as a fact that the taxpayer used this figure "in the belief that it was required to do so under the regulations then in effect." (R. 33a.) Accordingly, taxpayer's opening inventory for computing its net income for 1934 is $9,990,757.74. In all other cases in which a corporation filed a separate return for 1934 after having previously filed consolidated returns, the Treasury regulation was applied in the manner indicated, i. e., the exact figure of the proper closing inventory of 1933 is the correct figure for the opening inventory of 1934. *Magnolia Petroleum Co.* v. *Thomas,* 151 F. 2d 1008 (C. C. A. 5), certiorari

denied, 327 U. S. 799; *Tung-Sol Lamp Works* v. *United States* (S. D. N. Y.), decided December 7, 1942 (1943 C. C. H., par. 9202); *Bostonian National Shoe Stores* v. *Commissioner*, 39 B. T. A. 444.

The reasonableness of the Treasury Regulation is apparent. The principle upon which it is based is that no tax will be imposed upon the members of a group when property passes from one member to another even though the purchasing member actually pays cash and the selling member actually realizes a profit; the tax is deferred until the taxable year in which the group sells the property to an outsider, at which time the selling member is required to use a basis of cost to the group, not cost to the selling member, so that the profit on which the tax had been deferred is then subjected to a tax. See *Commissioner* v. *Liberty Nat. Co.*, 58 F. 2d 57 (C. C. A. 10), certiorari denied, 287 U. S. 603.*

* See also S. Rep. No. 960, 70th Cong., 1st Sess., p. 28 (1939–1 Cum. Bull. (Part 2) 409, 428); 8 Mertens, *Law of Federal Income Taxation* (1942), p. 524.

It is true as the Tax Court said in its opinion that later regulations are based upon a different principle. See Treasury Regulations 104, as amended, Section 23.39 (b) (3) (Appendix, *infra*, pp. 23–24). Under those Regulations, the result reached by the Tax Court might be correct if the intercompany profits were *in fact* eliminated from the opening inventory of 1918. But there is nothing in this record to show that they were eliminated; indeed the findings of the Tax Court indicate the contrary (R. 32a, 33a). In any event, those Regulations are in terms not applicable for years beginning prior to January 1, 1941.

Nor is the regulation inconsistent with the statute. Section 141 (b) gives the Commissioner the broadest possible authority to promulgate regulations for the period before and after affiliation so as to clearly reflect income and prevent tax avoidance. The regulation is legislative rather than interpretive in character and the only question which the Tax Court was free to decide was whether the Commissioner exceeded the authority delegated to him. *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 305; *Douglas* v. *Commissioner*, 322 U. S. 275, 280. It had no power to promulgate what it considered a better rule. The Tax Court did not in fact hold the regulation invalid, but accomplished the same result by ignoring the second sentence of Article 39 (b) and concluding that it was free to hold that the proper value of closing inventory in the last consolidated return and the proper value of the opening inventory in the first separate return was not cost to the group of the particular inventory (intercompany profits being eliminated), but rather cost to the taxpayer reduced only in the amount of those intercompany profits over the whole consolidated return period which the Tax Court assumed had not yet been taxed (R. 35a–36a). And its conclusion that this was a better rule as applied to this case was based upon several assumptions which its own findings did not support.

If all of the merchandise in taxpayer's closing inventory of 1933, which cost the taxpayer $18,422,333.66, but cost the group only $9,990,757.74, represented merchandise that had been manufactured during the period of affiliation, i. e., after January 1, 1918, then all of the intercompany profit on that merchandise, namely, $8,431,575.92, was never subjected to the income tax. But when that merchandise was sold to an outsider in 1934 or some later year, the taxpayer was required to use the same inventory cost that it had used during the period of affiliation, i. e., the cost to the group, which resulted in a tax being imposed upon the intercompany profit for the first time. Therefore, there would be no basis for the finding of the Tax Court that only $2,325,015.68 of the $8,431,575.92 intercompany profit in the closing inventory of 1933 escaped income taxes (R. 33a, 37a) unless all of the merchandise in the inventory of January 1, 1918, remained in the inventory for 16 years until December 31, 1933. It goes without saying that this would be very unlikely; the Tax Court did not find that this had occurred and there is certainly no evidence in the record to support such a finding.[1]

The Tax Court and the court below apparently were led astray by the testimony of taxpayer's witnesses who testified as to the method employed

[1] On the contrary, taxpayer's witnesses testified that it was improbable that *any* machines acquired prior to 1918 were in the closing inventory of 1933. (R. 16a, 22a.)

during the period of consolidated returns from January 1, 1918, through 1933 to compute consolidated net income. Briefly, they compared the intercompany profit at the beginning of each year with the intercompany profit at the end, and if the latter amount was larger they subtracted the difference from the total net income of the affiliated companies; if the latter amount was smaller, they added the difference to the net income of the affiliated companies. Although that method might be suitable to determine consolidated net taxable income during the period of consolidation (since the inclusion of intercompany profits in the opening inventory would be neutralized by a corresponding inclusion in the closing inventory), it nevertheless involves an incorrect use of inventories under the regulations, resulting in the distortion of net income for the period following consolidation. Morever, it will not serve to prevent tax avoidance because it leaves the intercompany profits intact in the opening and closing inventory of each year, and when the period of affiliation ends the intercompany profit in the closing inventory of the last consolidated return would remain in the opening inventory of the first year of separate returns, thus exempting the intercompany profits in that inventory from taxation at any time in the future. The intercompany profits thus included and thus freed from taxation, $8,431,575.92, must all have been earned during the consolidated return period,

during which they were not taxed. There is no finding of the Tax Court to the contrary, and, as we have said, *supra*, p. 11, it would be wholly unrealistic to assume that the 1933 and 1934 inventories contained any of the same products which were reflected in the 1918 inventory. While the Tax Court reduced the 1934 inventory in the amount of $2,325,015.68 of intercompany profits, $6,106,560.24 remained; thus $6,106,560.24 has not been taxed and, under the decisions below, may not be taxed in the future.

2. The decision of the court below is in conflict with the decision of the Fifth Circuit in *Magnolia Petroleum Co.* v. *Thomas, supra.* In that case the taxpayer, which was a member of an affiliated group filing a consolidated return for the year 1933, filed a separate return for the year 1934, because the Revenue Act of 1934 withdrew the privilege of filing consolidated returns except for railroad companies. In computing its opening inventory for 1934, the taxpayer included intercompany profit which was contrary to the Treasury Regulations. The Commissioner adjusted the taxpayer's opening inventory as of January 1, 1934, to the same figure as the closing inventory used in making the consolidated return for 1933, which resulted in the assessment of additional taxes. The taxpayer paid the additional taxes and sued for refund, but lost its suit both in the District Court and in the Circuit Court of Appeals. The case turned upon the validity of

the Treasury Regulations, the same Regulations involved in the instant case.

CONCLUSION

The amount of taxes here involved is the not unsubstantial sum of approximately $1,500,000. Since the decisions of the Tax Court and the court below are clearly wrong and there is a conflict of decisions, this petition for writs of certiorari should be granted.

Respectfully submitted.

GEORGE T. WASHINGTON,
Acting Solicitor General.

APRIL 1947.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

(1) *Inventory value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

* * * * *

(12) *Property acquired during affiliation.*—In the case of property acquired by a corporation during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the ap-

proval of the Secretary, without regard to inter-company transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928, shall be determined in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this Act of the Revenue Act of 1928, applicable to such period.

* * * * *

SEC. 141. CONSOLIDATED RETURNS OF CORPORATIONS.

(a) *Privilege to File Consolidated Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu

of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of 1928 in so far as not inconsistent with this Act) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *Regulations.* — The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) *Computation and Payment of Tax.*— In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under sub-

section (b), (or, in case such regulations are not prescribed prior to the making of the return, then the regulations prescribed under section 141 (b) of the Revenue Act of 1928 in so far as not inconsistent with this Act) prescribed prior to the date on which such return is made; except that for the taxable years 1932 and 1933 there shall be added to the rate of tax prescribed by sections 13 (a), 201 (b), and 204 (a), a rate of ¾ of 1 per centum.

* * * * *

Section 113 (a) (12) of the Revenue Act of 1928, c. 852, 45 Stat. 791, is substantially the same as Section 113 (a) (12) of the Revenue Act of 1932, set out above.

Sections 22 (c) and 141 (a) (b) and (c) of the Revenue Act of 1934, c. 277, 48 Stat. 680, are substantially the same as Sections 22 and 141 of the Revenue Act of 1932, set out above.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

(1) *Inventory value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

* * * * *

(11) *Property acquired during affiliation.*—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after

such period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to inter-company transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be determined in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141 (b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, applicable to such period.

* * * * *

Treasury Regulations 78, promulgated under the Revenue Act of 1932.

ART. 12. *Making Consolidated Return and Filing Other Forms.*

* * * * *

(b) *Authorizations and Consents Filed by Subsidiaries.*

Each subsidiary must prepare two duplicate originals of Form 1122, consenting to these regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent corporation (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the group), for each year thereafter for which, under article 11 (a), the making of a consolidated return is required. One of such forms shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for the district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

* * * * *

ART. 31. *Consolidated Net Income.*

(a) *Definition.*

Except as otherwise provided in these regulations, the consolidated net income of an affiliated group, which makes or is required to make a consolidated return for any taxable year, shall be the aggregate of the gross income of each of the members of such group less the aggregate of the allow-

able deductions of each of such members, except that gain or loss will not be recognized upon transactions between members of the group (referred to in these regulations as "intercompany transactions").

* * * * *

ART. 39. *Inventories.*

* * * * *

(b) *Separate Return Made After Consolidated Return.*

If a corporation has been a member of an affiliated group which has made a consolidated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, corporation S joins in making a consolidated return for 1932 and makes a separate return for 1933. The proper value of its closing inventory for 1932 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1933 will be $90,000.

Similar provisions appear in Article 39 (b), of Treasury Regulations 75, promulgated under Section 141 (b), Revenue Act of 1928, applicable to the taxable year 1929, and subsequent taxable years; also in Article 39 (b) of Treasury Regulations 89, promulgated under Section 141 (b) of the Revenue Act of 1934, applicable to the taxable years beginning after December 31, 1933.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

* * * * *

ART. 113 (a) (11)–1. *Basis of property acquired during affiliation.*—

* * * * *

The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under Regulations 75, Regulations 78, or Regulations 89, relating to consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under Regulations 75, Regulations 78, or Regulations 89, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. This rule is applicable, for instance, to the making of separate returns by the members of an affiliated group of corporations for taxable years beginning after December 31, 1933, due to the withdrawal under the law of the privilege of making consolidated returns. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1933 and is required to make a separate return for the taxable year 1934 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1934 is the proper value of the closing inventory used

in computing the consolidated net income for the preceding taxable year.

Treasury Regulations 104, promulgated under the Internal Revenue Code, as amended by T. D. 5127, 1942–1 Cum. Bull. 117, 127, and T. D. 5244, 1943 Cum. Bull. 439, 463:

SEC. 23.39. *Inventories.*

(a) *Years Beginning Prior to January 1, 1941.*

* * * * *

(2) *Separate return made after consolidated return.*

If a corporation has been a member of an affiliated group which has made a consolidated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, Corporation S joins in making a consolidated return for 1938 and makes a separate return for 1939. The proper value of its closing inventory for 1938 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1939 will be $90,000.

(b) *Years beginning after December 31, 1940.*

* * * * *

(3) *Separate returns made after consolidated returns.*

If a corporation which was a member of an affiliated group in a consolidated return period makes or is required to make a separate return for the succeeding taxable

year, the value of its opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of its closing inventory used in computing consolidated net income for the last consolidated return period increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group, but in an amount not exceeding, in the case of profits, either the amount of profits arising from such intercompany transactions reflected in the closing inventory of such corporation for such succeeding taxable year or the amount of such intercompany profits eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this subsection, and not exceeding, in the case of losses, either the amount of losses arising from intercompany transactions reflected in the closing inventory for such corporation for such suceeding taxable year or the amount of such intercompany losses eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this subsection.

U. S. GOVERNMENT PRINTING OFFICE: 1947

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Nos. 1303, 1304 and 1305

FILED
MAY 20 1947
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

SINGER SEWING MACHINE COMPANY.

On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF OF RESPONDENT IN OPPOSITION.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

Nos. 1303, 1304 and 1305.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

SINGER SEWING MACHINE COMPANY.

On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF OF RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 31a-38a)* is reported in 5 T. C. 851. The *per curiam* opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 40-41), affirming the decision of the Tax Court, is reported in 158 F. 2d 982.

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* The record references are to the Appendix to brief on behalf of the respondent taxpayer, Singer Sewing Machine Company, filed in the Circuit Court of Appeals, and to the appended proceedings in that court.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on January 30, 1947. (R. 41-44) The petition for writs of certiorari was filed April 29, 1947. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

The privilege of filing consolidated returns having been withdrawn by statute as to years subsequent to 1933 and consolidated returns having been filed for 1933 and earlier years, what is the "proper value," as prescribed by the revenue laws and the regulations thereunder, of Taxpayer's 1934 opening inventory.

The Taxpayer contends that the "proper value" was	$18,422,333.66
The Tax Court found that the actual closing 1933 inventory was $18,422,333.66, but that its "proper value" after elimination of intercompany profits not subjected to tax was	16,097,317.98
The Commissioner contends that it was	9,990,757.74

Since the value of the inventory affects the amount of profits on subsequent sales, the determination of the above question affects taxable income in 1934 on accrual sales and also in 1934, 1935, 1937 and 1938 on installment sales.

STATEMENT.

The petition for writs of certiorari filed herein does not correctly set out the questions involved in the Tax Court and the Circuit Court of Appeals, nor the effect of the decisions. Throughout the petition there is an implication that Respondent or its affiliated corporations earned income during the period of affiliation which was not subjected to tax by reason of filing consolidated returns. The implication has no support whatever in fact. The effect of the decision rendered by the Tax Court and the judgment entered

thereon was to subject every dollar earned by Respondent and its affiliated corporations to tax liability. The "statement" in the petition omits most of the material facts. It is respectfully suggested that a reading of the findings of fact and the opinion of the Tax Court (R. 32a-38a) will demonstrate the correctness of these assertions.

ARGUMENT.

Section 141(b) of the Revenue Act of 1932 is as follows:

> "(b) Regulations.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted *in such manner as clearly to reflect the income and to prevent avoidance of tax liability.*" (Italics added)

This section is the same as Section 141(b) of the Revenue Act of 1928 and was referred to in Section 113 of the Revenue Act of 1934 and made applicable to that year.

Pursuant to the authorization contained in the Statute, the Commissioner promulgated regulations. In Article 113(a)(11)-1 of Regulations 86, applicable to 1934, there is the following:

> "The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. This rule is applicable, for instance, to the making of separate returns by the members of an affiliated group of corporations for taxable years beginning after December 31, 1933, due to the withdrawal under the law of the privilege of making consolidated returns. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1933 and is required to make a separate return for the taxable year 1934 and succeeding taxable years, the value of the opening inventory

> to be used in computing such corporation's net income for the taxable year 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year."

It will be observed that the Regulations provide that the opening inventory for 1934 shall be the "proper value" of the closing inventory for 1933. The Tax Court determined that the inventory value in fact used in the consolidated return for 1933 was $18,422,333.66 (R. 33a). It then found as a fact that the proper opening inventory for 1934 was $16,097,317.98. The Court thus reduced the opening inventory in the amount of $2,325,015.68 and thereby added that amount to Respondent's income in 1934 and subsequent years, because that was the amount and the only amount which had not been subjected to tax during the period of consolidated returns. The Statute itself limited the power to make regulations and to make adjustments to the extent necessary to "reflect the income and to prevent avoidance of tax liability." Beyond this, as the Tax Court pointed out, the Commissioner could not go. The Commissioner, in the courts below attempted, and in this petition is attempting, to impose a tax on $6,106,560.24 greater profit than Respondent and its affiliated corporations ever made (R. 35a). The correctness of these statements clearly appears from the findings of fact and the opinion of the Tax Court.

The Tax Court found as a fact:

> "The petitioner, in its accounts and in all returns, used inventories taken upon the basis of cost or market, whichever was lower. * * * " (R. 32a)
>
> "The items in the 1918 opening inventory, which had been bought from Manufacturing, had been sold to the petitioner by Manufacturing prior to 1918 at a profit of $6,106,560.24. A similar intercompany profit in the 1918 closing inventory of the petitioner amounted to $8,245,474.67. The excess of the amount of intercompany profit in the closing inventory over the amount in the opening inventory of the petitioner was

subtracted on the consolidated return for 1918 from the total net income of the affiliated companies in determining consolidated taxable net income for 1918. This same system was used on all of the consolidated returns filed by the group except that the excess was added as consolidated income if the amount of intercompany profit in the opening inventory for a year was larger than the amount in the closing inventory of the petitioner for that year. The total subtractions exceeded the total additions on the consolidated returns for the years 1918 through 1933 by $2,325,015.68.

"The closing inventory of the petitioner used in the consolidated return for 1933 was $18,422,333.66. The intercompany profit represented in that amount was $8,431,575.92. The amount of intercompany profit of Manufacturing in the above closing inventory for 1933, which had escaped taxation under the system used by the petitioner and its affiliates, was $2,325,015.68." (R. 33a)

* * *

"The correct amount of the petitioner's opening inventory for 1934 is $16,097,317.98." (R. 33a)

The Tax Court stated additional pertinent facts in its opinion, including the following:

"The amount which he (the Commissioner) would eliminate from the opening inventory is not the amount of the profit of Manufacturing which has escaped tax under *the method heretofore used by these companies with the approval of the Commissioner. It is $6,106,560.24 greater than the profit which has escaped tax.*" (R. 34a-35a) (Italics added)

* * *

"* * * The adjustments washed out during the consolidated return period, except for the $2,325,015.68 of intercompany profits of Manufacturing which had not yet been reported in 1933 at the end of the consolidated return periods." (R. 35a)

* * *

"* * * The unrecognized gain in this case was $2,325,015.68 and we have adjusted the petitioner's opening inventory accordingly." (R. 37a)

The Tax Court properly applied the controlling statutes and regulations. It found that Taxpayer's closing inventory used in computing consolidated income for 1933 was $18,422,333.66; that intercompany profits in the amount of $2,325,015.68 had escaped tax on consolidated returns; and that the proper adjustment to determine the opening inventory for 1934 was subtraction of the $2,325,015.68 from the $18,422,333.66. It thus determined that the proper value of Taxpayer's opening inventory for 1934 should be $16,097,317.98.

Section 113(a)(11) of the Revenue Act of 1934 provides that, in the case of property acquired by a corporation from an affiliate during a period of affiliation, the basis of the property after affiliation shall be determined in accordance with regulations prescribed by the Commissioner "without regard to intercompany transactions in respect of which gain or loss was not recognized." The section makes applicable to 1934 the provisions of Section 141 of the Revenue Act of 1932, and regulations thereunder.

Section 113(a)(11) of the 1934 Act is the same as Section 113(a)(12) of the Revenue Act of 1928, in which Act the statutory provision originated. In its report on the provision in the 1928 Act, the Ways and Means Committee said:

> "* * * it is necessary to delegate to the Commissioner power to prescribe regulations legislative in character under which the basis will be determined for the computation of gain or loss, and depletion and depreciation, laying down in the section the general standard to guide the Commissioner that intercompany transactions should be disregarded if gain or loss was not recognized."

(House of Representatives Report No. 2, 70th Cong., p. 19-20; 1939-1 Internal Revenue Cumulative Bulletin, Part 2, p. 397. The Senate Finance Committee Report on the provision is to the same effect. Senate Report No. 960, 70th Cong., p. 28; 1939-1 Internal Revenue Cumulative Bulletin, Part 2, p. 428.)

The Tax Court determined that $2,325,015.68 of intercompany profit—and no more—had escaped tax on consolidated returns. It said that on the shift from consolidated returns to separate returns no greater burden should be imposed than necessary to protect the revenue, and determined that taxpayer's inventory of $18,422,333.66 should be reduced by the $2,325,015.68.

The Tax Court said (R. 37a):

> "* * * The implication is clear that no adjustment should be made for intercompany transactions in respect of which gain has been recognized. The unrecognized gain in this case was $2,325,015.68 and we have adjusted the petitioner's opening inventory accordingly. The statute and regulations require that and no more. This is now clearly spelled out in later regulations. See Regulations 104, sec. 23.39(b)(3)."

No Conflict of Decisions is Involved.

We challenge the statement in the petition that there is a conflict between the decisions of the Circuit Court of Appeals for the Third Circuit in these cases and the decision by the Circuit Court of Appeals for the Fifth Circuit in *Magnolia Petroleum Company* v. *Thomas,* 151 F. 2d 1008. The result of the decisions in both cases, as well as in the other cases cited in the petition, was the same. There was added in each case to taxable income for 1934 and subsequent years amounts which had not been subjected to tax during the period of consolidated returns.

The Taxpayer contended in the Tax Court and in the Circuit Court of Appeals that the Commissioner could not increase its taxable income in 1934 and subsequent years in the amount of $2,325,015.68 because it was income of another company and was earned prior to 1929, the effective date of the Revenue Act of 1928. Had the Circuit Court of Appeals sustained this contention there might have been a conflict. In fact, the Tax Court cited the above cases in support of its decision increasing Respondent's taxable income by the amount which was not subjected to tax during the consolidated period.

No Important Question of Federal Law is Involved.

In 1942, the Commissioner amended his regulations regarding consolidated returns. The regulations which have been in effect since that time and which apply to all years beginning after December 31, 1940, have expressly required that the opening inventory of a separate return following a consolidated returns period be adjusted exactly as the Tax Court and the Circuit Court of Appeals adjusted the taxpayer's opening inventory for 1934 in this case. It is submitted that this change in the regulation shows, as nothing else could, that the question involved is not only not an important question of law but is, in truth, only a question of proper accounting practice. Regulations 104, Sec. 23.39 (b)(3).

The Tax Court's Valuation is Final.

The determination of the "proper value" of the Taxpayer's 1934 opening inventory is final and controlling under the principle of *Dobson* v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239. The situation in the *Dobson* case was very similar in all pertinent particulars to the one in these proceedings. Both cases involve basis and the controlling guide in each case is the term "proper." In the *Dobson* case the Court was dealing with a statutory provision that "proper adjustment shall in all cases be made" for certain items if "properly chargeable to capital account." In these proceedings the statutory provision (Section 141 of the Revenue Acts of 1928, 1932 and 1934) authorized the Commissioner to promulgate regulations to clearly reflect income of the affiliated group and of each corporation in the group to the end that no income would escape taxation during the consolidated return period or on the termination thereof. The regulations provided that the opening inventory for the first year of separate returns should be the "proper value" closing inventory of the consolidated return period.

In the *Dobson* case the Supreme Court said, page 504:

> "What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine."

"Proper value" of inventory involved in these proceedings, which is used to determine a profit or loss on sales of the year, and "proper adjustment" of basis involved in the *Dobson* case to be used in determining gain or loss, it would seem, cannot be distinguished for purposes of the rule of the *Dobson* case. The "proper value" is clearly a valuation and accounting problem, and, likewise, inventory accounting to clearly reflect income is certainly an accounting problem. See also *Kelley Co.* v. *Commissioner* and *Talbot Mills* v. *Commissioner*, 326 U. S. 521.

CONCLUSION.

The result of the decision in the Tax Court, which was affirmed by the Circuit Court of Appeals, was to subject to taxation every dollar of income made by Taxpayer and its affiliated corporations. The Commissioner is attempting to subject to tax over $6,000,000 more than was in fact earned by the group of corporations. On the question of principle, we do not see that the amount involved is relevant. In *Ventura Consolidated Oil Fields* v. *Rogan*, 86 F. 2d 149, 156, the Circuit Court of Appeals for the Ninth Circuit stated:

> "We are unable to discover any difference in the applications of the rules of law or equity in tax cases,

whether the government's claim be for $100 or $10,000,000."

Respectfully submitted,

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